



To: Wood Miller, Chair, Uniformity Committee

From: Chis Coffman, Chair, Section 18 Model Regulations Working Group
Bruce Fort, Counsel, Multistate Tax Commission

Date: 7/22/16

Re: Report on Activities of Section 18 Model Regulation Working Group

The Uniformity Committee's "Section 18" working group met regularly by telephone conference on a weekly basis from mid-January 2016 through May 10, 2016.¹ The working group's mission is to create drafts of proposed model regulations addressing the use of alternative apportionment under Compact Article IV, Section 1(g) and 17, pertaining to the new definition of gross receipts and market-based sourcing, respectively. The Commission's webpage for the working group, which contains agendas, minutes of meetings and working drafts, can be found here: <http://www.mtc.gov/Uniformity/Project-Teams/Section-18-Regulatory-Project>.

The subcommittee suspended its meetings following a May 12 meeting of the Executive Committee of the Commission, which considered the report by Hearing Officer Brian Hamer on the Uniformity Committee's proposed Section 1 and Section 17 model regulations. At the May 12 meeting, several comments were received proposing that definitions and sourcing rules relating to receipts from hedging transactions, securities and interest should be included in the Section 1/Section 17 model regulations, instead of or in addition to addressing those topics as special industry regulations under authority of Section 18. The Executive Committee asked the Uniformity Committee to consider the comments and to report back to it. Because it was felt that the undertaking by the full Uniformity Committee would likely overlap or conflict with the Section 18 drafting efforts, the working group chair decided to suspend the efforts of that group.

Prior to the suspension of meetings, the working group primarily addressed its efforts to developing sourcing rules for so-called "functional-test" gross receipts, and in particular, income derived from interest, dividends, and capital gains. These are income types which will ordinarily be eliminated from the apportionment formula. However, there are some circumstances where eliminating those types of income from the apportionment formula would result in a failure to capture the taxpayer's business presence within the states. The working group concluded that the most appropriate circumstance for

¹ The working group is chaired by Chris Coffman, Washington, and is staffed by counsel for the Multistate Tax Commission. The Commission wishes to thank the following state participants in particular for their advice and suggestions: Holly Coon, Alabama; Michael Fatale, Massachusetts; Phil Skinner and Nate Neilson, Idaho; Scott Fryer, Arkansas, Dee Wald and Matt Peyerl, North Dakota; Jason Larimer and Don Jones, Oregon; Jennifer Hays, Kentucky, Richard Botwright, Pennsylvania; and James Savage, Virginia.

allowing inclusion of such income items as receipts would be a taxpayer which did not have a sufficient percentage of income derived from “transactional receipts” (receipts from transactions and activity in the regular course of business) to enable appropriate marking-based apportionment of income.

The subcommittee delayed developing rules for special industries, including securities dealers, in favor of proceeding with sourcing rules of more general application. Additionally, the working group recognized that sourcing rules for partnership (pass-through entity) distributions might be appropriate, but deferred taking action on that topic since the Uniformity Committee is expected to form a separate partnership study group. Finally, the working group did not take up action on defining hedging transactions in the event it was considered appropriate to source income from such transactions in exceptional circumstances for special industries.

While the working group did not finish its work on sourcing receipts for taxpayer without “transactional” income, and did not adopt any proposed recommendation for how and where to source income from assets used in the business, the working group did consider some guidelines which bear mention.²

The working group gave consideration to a draft model regulation which would be applicable to any taxpayer having less than 3% of its gross receipts derived from “transactional” activities, which would establish a hierarchy of rules for apportionment. Under the proposal, the primary sourcing would be as follows:

1. interest and investment income for non-financial institutions would be sourced under the state’s financial institutional apportionment rule, or under the MTC model of the same name if no special industry rule for such entities had been adopted;
2. Dividend income would be sourced to the payor’s business locations;
3. Capital gains from the sale of a business or business segment would be sourced to the location of that entity’s business location, using the entity’s receipts factor where the sale was primarily classified as the sale of goodwill, and to the location of the entity’s property factor for sales of hard assets.

The secondary sourcing rule, if the primary sourcing is inapplicable, would be to the location of the taxpayer’s property and payroll (where the state uses multiple apportionment factors).

The tertiary rule would source income according to the apportionment percentages of the taxpayer’s related business (unitary filing group, if any), or to the location of the taxpayer’s primary beneficial owner, if identifiable;

The last sourcing rule in the hierarchy was a “catch-all” that the income should be apportioned equitably in relationship to activities in each state, perhaps with a reference to cost of performance principles.

² This memorandum is intended to be educational and explanatory in nature and does not represent the Commission’s legal interpretation of Article IV of the Compact, proposed or existing model regulations, or committee discussions and deliberations. Additionally, this memorandum is intended to offer drafting suggestions for the working group’s consideration and does not constitute a recommendation by the Commission or its staff as to the advisability of any suggestion, idea or proposal.

The most recent draft language is available here:

http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-18-Regulatory-Project/Sec-18-general_rules5-10-16_committeechanges.pdf.aspx.

The working group stands ready to continue its efforts to draft special industry apportionment regulations pertaining to Article IV, Sections 1 and 17 as soon as the Uniformity Committee directs.

In addition to the income sourcing identified above, it should be noted that Compact Article IV, Section 18 was amended in 2014 to establish certain evidentiary and procedural rules for alternative apportionment. The working group may wish to consider whether model regulations would be appropriate for implementing those changes to alternative apportionment practice and procedures.